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October 22, 2015

# SO, WHO PAYS? THE KENTUCKY SUPREME COURT CLARIFIES WHERE THE BURDEN TO PAY THE STATE SEVERANCE TAX ON NATURAL GAS LIES.

[Natural Resource \(/full-blog?category=Natural+Resource\)](/full-blog?category=Natural+Resource), [Impact! \(/full-blog?category=Impact%21\)](/full-blog?category=Impact%21)

By: Samuel Smith

Recently, in the case of *Appalachian Land Co. v. EQT Production Co.*, the Supreme Court of Kentucky considered a certified question of law from the U.S. Court of Appeals for the Sixth Circuit, namely:

Does Kentucky's "at-the-well" rule allow a natural-gas processor to deduct all severance taxes paid at market prior to calculating a contractual royalty payment based on "the market price of gas at the well," or does the resource's at-the-well price include a proportionate share of the severance taxes owed such that a processor may deduct only that portion of the severance taxes attributable to the gathering, compression and treatment of the resource prior to calculating the appropriate royalty payment?<sup>[i]</sup>

This question came to the Supreme Court as a result of a class action suit filed by Appalachian in 2008 in the U.S. District Court for the Eastern District of Kentucky, claiming that EQT had not paid the full amount of royalties due for natural gas that EQT had extracted from land that Appalachian owned.<sup>[ii]</sup> Appalachian contended that EQT's deduction of severance taxes should not have been factored into the calculation for determining the "market price" to be used to determine payment royalties. Therefore, this improper calculation method caused EQT to underpay Appalachian for royalties.<sup>[iii]</sup> The District Court ruled in favor of EQT, Appalachian then appealed to the Sixth Circuit, and then the Sixth Circuit certified the above-noted question to the Kentucky Supreme Court, setting the stage for the court's decision in the case.<sup>[iv]</sup>





(<http://www.fracturedappalachia.org/documentary/radio-documentary-pt-v-drilling/>)

In response to the question posed by the Sixth Circuit, the Kentucky Supreme Court ultimately ruled that, “1) royalty owners are not statutorily liable for the severance tax assessed under KRS Chapter 143A; and 2) absent a specific contractual provision apportioning severance taxes, lessees may not deduct severance taxes or any portion thereof prior to calculating a royalty value.”[v] Therefore, EQT improperly deducted the severance taxes in calculating the royalties it owed to Appalachian. Interestingly, the court’s ruling refused to adopt either of the possible options posed by the Sixth Circuit, and merely disallowed, by default, any severance tax deductions by a lessee in the calculation of royalties. In reaching its decision, the court focused mainly on the text of KRS 143A.020,[vi] the statute that details the mechanics of Kentucky’s severance tax on natural gas. The court found that according to the plain meaning of the statute and also in regard to the holding in the case of *Burbank v. Sinclair Prairie Oil Co.*,[vii] the law in Kentucky was such that the severance tax should be imposed only on the party actually severing or processing the gas and not on parties who were mere royalty owners.[viii]

The majority opinion did, however, garner a dissent from Justice Abramson, to which Chief Justice Minton also joined. The dissent determined that the second option proposed by the Sixth Circuit, which was the amount of the severance tax based on the post-extraction processing costs that may be deducted before determining the royalty amount, was the appropriate answer to the question posed. [ix] The dissent argued that the provisions of KRS Chapter 143A, as a whole, retained a distinction between the actual severing of the gas from the earth and the post-severance processing of the resource obtained. Therefore the one who actually extracted the resource from the earth was undoubtedly accountable for that portion of the tax. However, the extractor was not, absent a contractual agreement to the contrary, accountable for the post-severance processing portion of the tax.[x]

Although the Kentucky Supreme Court took its own path in answering the question of law the Sixth Circuit posed, the court’s answer is supported not only by Kentucky statutes but also Kentucky case law. As natural gas production in Kentucky continues to rise, the court’s clarification on this part of the law will hopefully help to prevent future disputes of this kind.

[i] *Appalachian Land Co. v. EQT Prod. Co.*, No. 2013-SC-000598-CL, 2015 Ky. LEXIS 1749, at \*3-4 (Ky. Aug. 20, 2015).

[ii] *Id.* at \*2.

[iii] *Id.* at \*3.

[iv] *Id.*

[v] *Id.* at \*19.

[vi] Ky. Rev. Stat. Ann. § 143A.020 (LEXIS 1980).

[vii] *Ser Burbank v. Sinclair Prairie Oil Co.*, 202 S.W.2d 420 (Ky. 1946).

[viii] *In re Appalachian Land Co.*, 2015 Ky. LEXIS 1749, at \*11.

[ix] *Id.* at \*22 (Abramson, J., dissenting).

[x] *Id.* at \*47-48 (Abramson, J., dissenting).

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